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SENSITIVE  
SIPDIS

DEPARTMENT PASS TO EEB JENNIFER PETERSON  
DEPARTMENT PASS TO TREASURY FOR MALACHY NUGENT/ATTICUS  
WELLER AND MARY BRENNAN  
DEPARTMENT PASS TO USTR FOR MICHAEL DELANEY AND VICTORIA  
KADER

E.O. 12958: N/A

TAGS: CE ECON EFIN ETRD KTEX PGOV

SUBJECT: CENTRAL BANK GOVERNOR CONFIDENT ON ECONOMIC GROWTH  
AND RECONSTRUCTION; DEFENSE BUDGET IS SRI LANKA'S BUSINESS

REF: COLOMBO 944

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¶1. (SBU) Summary. In his introductory meeting with Ambassador Butenis, Sri Lankan Central Bank Governor Ajith Nivard Cabraal described the Sri Lankan economy as strong. Cabraal expects Sri Lanka to make large strides in the reconstruction of the conflict areas in the North and East. Cabraal parried questions about the economic impact of Sri Lanka's strained political relationship with the West by returning to his theme about the strength of the Sri Lankan economy. Cabraal expressed confidence that Sri Lanka would generally meet the IMF targets to reduce GSL budget deficits, although he allowed that the IMF realizes that the GSL may go over the targets for reconstruction spending. Cabraal denied any connection between the IMF and defense spending, maintaining that the IMF only sought to reduce government deficits, and it was up to the GSL how to spend the money. Finally, the GSL is prepared with an assistance package for the private sector if the European Union withdraws GSP Plus trade preference benefits. End Summary.

#### A Strong Economy Allows Sri Lanka to Meet IMF Targets

¶2. (U) The Sri Lankan economy has weathered the global downturn well, according to the Central Bank Governor. Cabraal thought that Sri Lankans had regained their economic confidence, highlighted by a booming stock market (see reftel). He rattled off the familiar positive economic statistics: the Central Bank has raised its growth estimates from 2.4 percent to 3.5 percent for 2009 and expects 6 percent growth in 2010; inflation has fallen from 26 percent to 1 percent; interest rates have dropped from 23 percent to 9 percent; and foreign exchange reserves have grown from 2 to 5 months of import cover.

¶3. (SBU) Cabraal asserted that Sri Lanka is on line to meet its IMF targets. He noted that the IMF program lends confidence to the Sri Lankan economy, and it is still important for the GSL to stick to the IMF program to maintain investor confidence. Cabraal stated that the GSL has greatly benefited from falling interest rates, which have

substantially reduced the GSL's debt payments. (Note. Sri Lanka's debt service constituted 21 percent of its government budget in 2008, so interest rate savings are substantial. End Note.) The IMF budget targets will not constrain GSL spending for reconstruction of the North and East, he maintained. The IMF recognized that national reconstruction costs are a priority and that the deficit targets could be adjusted. New IMF representative Koshy Mathai essentially confirmed this view. The IMF recognizes that Sri Lanka is at an historic moment, and as long as the reconstruction spending is reasonable the IMF could make some allowances on its deficit targets.

#### Reconstruction of the North and East

¶4. (SBU) According to Cabraal, there has been great progress rebuilding the Eastern part of the country liberated from the LTTE several years ago, and the GSL will apply the same model to the North. The GSL has emphasized road construction, and the government is looking for donor assistance to help rehabilitate more roads. The East, traditionally a breadbasket of Sri Lanka, has begun cultivation of crops. The GSL also has a microcredit lending program that has made 1,900 loans to families. The next step is to rebuild more police stations, schools, and hospitals. Cabraal believes that the North has great potential to contribute to overall growth. For example, in 1982, before the conflict began, the North exported 50,000 metric tons of fish, but in 2007 Northern fishermen exported a mere 7,000 metric tons of fish.

#### GSL Will Decide Its Defense Budget; Not the IMF

¶5. (SBU) Ambassador Butenis questioned why the GSL had  
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increased its defense spending by 15 percent in a supplementary budget request and asked if this would be an issue with the IMF. Cabraal argued that it was up to the GSL to determine its own internal spending targets, and the IMF was only concerned with the overall government deficit numbers. Therefore, if the government spends more on the military, as long as the GSL cuts spending elsewhere or raises revenue sufficiently to reduce the overall budget deficit, the IMF should be satisfied. IMF Representative Mathai would not put the issue quite so baldly, since the IMF does pay attention to the composition of the budget. However, Mathai stressed that the IMF would respect a sovereign government's spending priorities. Mathai thought that Sri Lanka would need to show some defense savings in the 2010 budget to meet the IMF government budget deficit target of 6 percent of GDP, but Mathai noted that the GSL military is performing many non-military roles in the North, including reconstruction and police work.

#### Impact of Political Tensions on the Economy

¶6. (SBU) On several occasions Ambassador Butenis noted that political tension over the end of the war and the closed IDP camps could impact the economy. Cabraal sidestepped these concerns by returning to his overall picture of a strong Sri Lankan economy, and he never directly addressed the potential for economic costs due to political tensions.

#### GSL Plan to Cope with the Possible Loss of GSP Benefits

¶7. (SBU) After the Cabraal meeting, the European Commission recommended to the European Union revoke Sri Lanka's GSP Plus benefits on human rights grounds, which would result in an estimated USD150 million trade loss for Sri Lanka. The EU process is lengthy, and even if the EU finally decides to revoke GSP Plus benefits, this will not occur until mid 2010. Cabraal anticipated this issue, and claimed that the GSL was ready with a 'Plan B' if Sri Lanka lost GSP Plus. The GSL would provide subsidies to exporters for up to one year, and Cabraal also expected that the

exporters would benefit from interest rate reductions and lower electricity prices (because several coal plants are due to come on line). In the end, he believed that the exporters could adjust to the loss of GSP Plus.

¶8. (SBU) Comment. Governor Cabraal is an excellent salesman who skillfully made the case that Sri Lanka's economy is in good shape and does not need further assistance. Although the GSL likes to portray itself as fine without GSP Plus and maintains that Sri Lanka can ride out any donor ire about its military spending, we continue to emphasize that the political tensions have economic consequences, hope that this message is getting through to GSL leadership. The GSL has been very concerned about the potential loss of GSP Plus benefits, and it must know that it needs substantial donor assistance to rebuild the North and East. End Comment.

BUTENIS